



## BUSINESS LAW SECTION

THE STATE BAR OF CALIFORNIA

### **LEGISLATIVE PROPOSAL (BLS-2008-08) INTERNET POSTING OF ANNUAL REPORTS**

To: Larry Doyle, Office of Governmental Affairs

From: Steven R. Harmon, Vice-Chair, Legislation,  
Corporations Committee, Business Law Section

Date: September 14, 2007

Re: Proposal to Amend §1501(a) of the California Corporations Code

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#### **SECTION ACTION AND CONTACTS**

Date of Approval by Section Executive Committee: September 12, 2007

Approval Vote: (Delegating Authority to the Legal Subcommittee).

For: 15                      Against: 0

Date of Approval by Legislative Subcommittee of the Section Executive Committee:  
September 14, 2007

Approval Vote:              For: 4                      Against: 0

Date of Approval by Corporations Committee: September 7, 2007

Approval Vote: (Delegating Authority to it Subcommittee)

For: 14                      Against: 0

Date of Approval by Corporations Committee Subcommittee: September 13, 2007

Approval Vote:              For: 4                      Against: 0

<b>Executive Committee Contact:</b>	<b>Corporations Committee Contact:</b>
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## **HISTORY, DIGEST AND PURPOSE**

The mission statement of the Corporations Committee (the “Committee”) of the Business Law Section (the “Section”) provides that it shall study, consider, and take a position on and advocate that position with respect to, among other things, “Needed changes to the California Corporations Code” and, “Other statutory changes that would promote efficiency or effectiveness in practice if made . . .” The Committee has concluded that it is consistent with this mission to propose amendment of §1501(a) of the California Corporations Code (the “Code”) to conform its requirements to the recent amendments of the proxy rules under the Securities Exchange Act of 1934, as amended (the “Exchange Act”) (17 C.F.R. Section 240.14).

### **History.**

§1501 was enacted as part of the General Corporation Law (the “GCL”) adopted in 1975 that became effective on January 1, 1977 (Stats. 1975, ch. 682). That provision requires the board of directors of a domestic corporation and a foreign corporation having its principal executive office in California or customarily holding meetings of its board of directors in California to cause an annual report to be sent to shareholders. The second sentence of §1501(a), the subject of this proposal, was added by an amendment enacted in 2004 (Stats. 2004, ch. 254) to permit the annual report and any accompanying material to be sent to shareholders by “electronic transmission by the corporation” as such term is defined by Section 20. §1501 was also amended in 1977 (Stats. 1977, ch. 235), 1978 (Stats. 1978, ch. 370), 1982 (Stats. 1982, ch. 36), 1984 (Stats. 1984, ch. 335), and 2006 (Stats. 2006, ch. 214), none of which amendments affect the subject or substance of this proposal.

§20 was added to the Code by an amendment enacted in 2004 (Stats. 2004, ch. 254). Prior to this revision, the Code (including the GCL) did not contain analogous language. §20 has not been amended since it was enacted in 2004.

### **Relevant Existing Code Sections.**

***Section 1501(a):*** Section 1501(a) of the Code requires the board of directors of a domestic corporation and a foreign corporation having its principal executive office in California or customarily holding meetings of its board of directors in California to cause an annual report meeting the requirements of Section 1501 of the Code to be sent to shareholders. Unless otherwise provided by the corporation’s articles or bylaws and if approved by the board of directors of the corporation, the annual report and any accompanying material sent pursuant to Section 1501 of the Code may be sent by electronic transmission by the corporation as defined under Section 20 of the Code.

***Sections 1501(g) and Section 2115:*** Section 1501(g) of the Code provides that Section 1501(a) applies to any domestic corporation and also to a foreign corporation having its principal executive office in California or customarily holding meetings of its board in California. In addition, Section 1501(a) applies to quasi-domestic corporations pursuant to Section 2115.

***Section 20: “Electronic Transmission by the Corporation.”*** Section 20 of the Code applies to a corporation desiring to make any communication either entirely or partially by electronic means.

Each corporation desiring to communicate electronically must meet three requirements related to method of delivery, authorization, and record retention.

*Method of delivery.* Section 20 of the Code allows electronic transmissions in the form of a facsimile telecommunication, electronic mail, posting to an electronic message board or other means of electronic communication. In the case of a facsimile telecommunication or electronic mail, the transmission must be sent to the number or address that is on record with the corporation for that recipient. In the case of a posting to an electronic message board, the posting must be accompanied by a separate notice to the recipient.

*Authorization.* A recipient must have provided an unrevoked consent to the use of electronic transmissions. In addition, if the communication is to an individual shareholder or member, it must also meet the requirements of the Electronic Signatures in Global and National Commerce Act.

*Record Retention.* The electronic transmission must be capable of retention, retrieval and review and must be able to be transferred into tangible form.

### **Proposal.**

The proposed revisions to §1501(a) of the Code would permit a corporation that has an outstanding class of securities registered under Section 12 of the Exchange Act to satisfy the obligation to send an annual report to shareholders under Section 1501 by complying with Rule 14a-16 of the Exchange Act. The proposed revisions would not affect the contents of the annual report or otherwise change the requirements of Section 1501.

### **Reasons for the Proposal.**

On July 26, 2007, the Securities and Exchange Commission (the “SEC”) recently adopted amendments to the proxy rules under the Exchange Act that provide an alternative method for issuers to furnish proxy materials, including the proxy statement, proxy card and annual report, to shareholders by posting them on an internet website and providing shareholders with written notice of the availability of the proxy materials at least 40 calendar days before the meeting date. Under this “notice and access” system, issuers are required to make copies of the proxy materials available to shareholders on request, at no charge to shareholders within three business days after receiving the request, even if the request is made after the date of the shareholder meeting or corporate action to which the proxy materials relate. The obligation of the issuer to furnish the proxy materials extends for one year after the conclusion of the meeting or corporate action.

The SEC’s recently amended proxy rules allow corporations to benefit from technological advancements by providing shareholders with access to proxy materials electronically. However, the effect of Sections 1501(a) and 20 of the Code is to limit significantly the ability of a corporation to take advantage of the new SEC rules by requiring a corporation to obtain an unrevoked consent from a shareholder for the electronic receipt of materials and to comply with the requirements applicable to consumer consent to electronic records under the Electronic Signatures in Global and National Commerce Act (15 U.S.C. Sec. 7001(c)(1)).

Since adoption of the new SEC proxy rules, §1501(a) of the Code, when read together with Section 20 of the Code, has been frequently cited by practitioners as an impediment to transacting business by corporations subject to it. The existing requirement for the use of an electronic transmission by a corporation of an annual report under §1501(a) will make it impractical for corporations to avail themselves of the new SEC rules. As a result, California corporations and corporations headquartered in California will not be able to take advantage of technological improvements that corporations in other states will be. In 2004, California was at the forefront of technological advancements with the adoption of Section 20 and amendment of §1501(a) to permit electronic transmissions of the annual reports. However, absent the proposed amendment to §1501(a), California will fall behind other states in its promotion and use of technology as a means to communicate with shareholders.

In addition, corporations covered by §1501(a) of the Code will be unable to achieve the cost savings afforded by the new SEC proxy rules. A recent illustration prepared by Morrow & Co., Inc., and posted by The Corporate Counsel estimated that potential annual savings from corporations taking advantage of the new SEC proxy rules would be approximately \$76,000 a year beginning in only the second year of adoption.<sup>a</sup> The inconsistency between California law and federal law will place California corporations at a competitive disadvantage and may discourage corporations from incorporating in California or remaining incorporated in California and it may discourage foreign corporations from establishing their headquarters in California or motivate foreign corporations to move their headquarters out of California.

#### APPLICATION

If adopted, the proposed amendment to §1501(a) would become effective January 1, 2009; however, we would propose that the amendment be considered urgency legislation to permit immediate effectiveness upon its passage.

#### PENDING LITIGATION

None to our knowledge.

#### LIKELY SUPPORT AND OPPOSITION

We anticipate that the proposed amendment to §1501(a) would receive the strong support of California corporations, corporations operating in California, investors and corporate law practitioners. Despite the ability of shareholders to request paper copies of the annual report, some opposition from shareholder rights advocates may be possible.

#### FISCAL IMPACT

No negative fiscal impact is expected. Providing incentive for corporations to incorporate or remain incorporated in California, or establish headquarters or remain headquartered in California, would have a positive fiscal impact and the proposed amendments are intended to serve that function.

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<sup>a</sup> Based on an assumption of 100,000 total shareholders and current costs of \$455,000 per year.

## GERMANENESS

The subject matter of the proposed amendment of §1501(a) is one in which the members of the Section (and, in particular, the members of the Committee) have special experience since they prepare the documentation for the various reports covered by this proposal. The subject matter requires the special knowledge, training, experience, and technical expertise of the Section. In addition, the proposed amendment would promote clarity, consistency, and comprehensiveness of the law.

## TEXT OF PROPOSAL

SECTION 1. Section 1501 of the Corporations Code is amended to read:

1501. (a) The board shall cause an annual report to be sent to the shareholders not later than 120 days after the close of the fiscal year, unless in the case of a corporation with less than 100 holders of record of its shares (determined as provided in Section 605) this requirement is expressly waived in the bylaws. Unless otherwise provided by the articles or bylaws and if approved by the board of directors, that report and any accompanying material sent pursuant to this section may be sent by electronic transmission by the corporation (Section 20). *The obligation of the board to cause an annual report to be sent to shareholders under this Section 1501 shall be satisfied if a corporation that has an outstanding class of securities registered under Section 12 of the Securities Exchange Act of 1934 complies with Section 240.14a-16 of Title 17 of the Code of Federal Regulations, as it may be amended from time to time, with respect to the obligation of a corporation to furnish an annual report to shareholders pursuant to Section 240.14a-3(b) of Title 17 of the Code of Federal Regulations.* This report shall contain a balance sheet as of the end of that fiscal year and an income statement and a statement of cashflows for that fiscal year, accompanied by any report thereon of independent accountants or, if there is no report, the certificate of an authorized officer of the corporation that the statements were prepared without audit from the books and records of the corporation.

Unless so waived, the report shall be sent to the shareholders at least 15 (or, if sent by third-class mail, 35) days prior to the annual meeting of shareholders to be held during the next fiscal year, but this requirement shall not limit the requirement for holding an annual meeting as required by Section 600.

Notwithstanding Section 114, the financial statements of any corporation with fewer than 100 holders of record of its shares (determined as provided in Section 605) required to be furnished by this subdivision and subdivision (c) are not required to be prepared in conformity with generally accepted accounting principles if they reasonably set forth the assets and liabilities and the income and expense of the corporation and disclose the accounting basis used in their preparation.

(b) In addition to the financial statements required by subdivision (a), the annual report of any corporation having 100 or more holders of record of its shares (determined as provided in Section 605) either not subject to the reporting requirements of Section 13 of the Securities Exchange Act of 1934, or exempted from those reporting requirements by Section 12(g)(2) of that act, shall also describe briefly both of the following:

(1) Any transaction (excluding compensation of officers and directors) during the previous fiscal year involving an amount in excess of forty thousand dollars (\$40,000) (other than contracts let at competitive bid or services rendered at prices regulated by law) to which the

corporation or its parent or subsidiary was a party and in which any director or officer of the corporation or of a subsidiary or (if known to the corporation or its parent or subsidiary) any holder of more than 10 percent of the outstanding voting shares of the corporation had a direct or indirect material interest, naming the person and stating the person's relationship to the corporation, the nature of the person's interest in the transaction and, where practicable, the amount of the interest; provided that in the case of a transaction with a partnership of which the person is a partner, only the interest of the partnership need be stated; and provided further that no report need be made in the case of any transaction approved by the shareholders (Section 153).

(2) The amount and circumstances of any indemnification or advances aggregating more than ten thousand dollars (\$10,000) paid during the fiscal year to any officer or director of the corporation pursuant to Section 317; provided that no report need be made in the case of indemnification approved by the shareholders (Section 153) under paragraph (2) of subdivision (e) of Section 317.

(c) If no annual report for the last fiscal year has been sent to shareholders, the corporation shall, upon the written request of any shareholder made more than 120 days after the close of that fiscal year, deliver or mail to the person making the request within 30 days thereafter the financial statements required by subdivision (a) for that year. A shareholder or shareholders holding at least 5 percent of the outstanding shares of any class of a corporation may make a written request to the corporation for an income statement of the corporation for the three-month, six-month or nine-month period of the current fiscal year ended more than 30 days prior to the date of the request and a balance sheet of the corporation as of the end of the period and, in addition, if no annual report for the last fiscal year has been sent to shareholders, the statements referred to in subdivision (a) for the last fiscal year. The statements shall be delivered or mailed to the person making the request within 30 days thereafter. A copy of the statements shall be kept on file in the principal office of the corporation for 12 months and it shall be exhibited at all reasonable times to any shareholder demanding an examination of the statements or a copy shall be mailed to the shareholder.

(d) The quarterly income statements and balance sheets referred to in this section shall be accompanied by the report thereon, if any, of any independent accountants engaged by the corporation or the certificate of an authorized officer of the corporation that the financial statements were prepared without audit from the books and records of the corporation.

(e) In addition to the penalties provided for in Section 2200, the superior court of the proper county shall enforce the duty of making and mailing or delivering the information and financial statements required by this section and, for good cause shown, may extend the time therefor.

(f) In any action or proceeding under this section, if the court finds the failure of the corporation to comply with the requirements of this section to have been without justification, the court may award an amount sufficient to reimburse the shareholder for the reasonable expenses incurred by the shareholder, including attorneys' fees, in connection with the action or proceeding.

(g) This section applies to any domestic corporation and also to a foreign corporation having its principal executive office in this state or customarily holding meetings of its board in this state.